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From:	General Secretariat of the Council
To:	Delegations
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Subject:	Code of Conduct (Business Taxation) – Scoping paper on criterion 2.2 of the EU listing exercise

Delegations will find in Annex the Scoping paper on criterion 2.2 of the EU listing exercise, as endorsed by the Council at its meeting held on 22 June 2018 (see doc. 10373/18).

ANNEX

Scoping paper on criterion 2.2 of the EU listing exercise

I/ Technical elements of commitments to be fulfilled by the jurisdictions

Issue of lack of substance (Criterion 3 of the Code of Conduct test)

To address the issues that arise in connection with entities operating without any substance, the 2.2 jurisdictions have already been requested by the COCG to:

1) *give reassurances to EU Member States on this issue, in line with the Terms of Reference attached to this letter;* and
2) *discuss with the Code what further steps could better ensure that businesses have sufficient economic substance.*

The letters to these jurisdictions clarified that

"*a way to achieve this could be through the imposition of substance requirements, where appropriate. Moreover, this may require that you introduce additional accounting and tax reporting obligations such that an appropriate notification regime for entities that give rise to the risks and concerns underlying criterion 2.2 can ensure the collection and subsequent exchange of relevant information with Member States*."

In line with the Criterion 2.2 ToR (see Annex 1) and further discussions held in the context of the COCG, the dialogue with the jurisdictions has started on the basis of the below points:

1) The jurisdiction has provided concrete elements on the steps (including their timeline) envisaged to align their legal system with the ToR on criterion 2.2;
2) The jurisdiction shall guarantee that legal substance requirements will be introduced in the legislation for the incorporation and operation of entities making sure that in practice tax advantages (i.e. no or very low taxation) are not granted to entities without any real economic activity and substantial economic presence in the jurisdiction.
3) Taking into account the features of each specific industry or sector, the jurisdiction should be asked to introduce requirements concerning an adequate level of (qualified) employees, adequate level of annual expenditure to be incurred, physical offices and premises, investments or relevant types of activities to be undertaken.
4) The jurisdiction shall also ensure that the activities are actually directed and managed in the jurisdiction and that core income-generating activities are performed in the jurisdiction. The jurisdiction shall in addition provide a guarantee that appropriate resources are deployed by governmental authorities, including tax authorities, to check the application of these requirements and that sanctions are envisaged in case of non-compliance.

5) The jurisdiction shall introduce appropriate notification regimes whereby all information needed to assess the actual amount of profits booked in the jurisdictions could be made available to the relevant jurisdictions having in place CIT system for the purpose of calculating the tax liability of their taxpayers. The jurisdiction has to ensure that information are collected, accessed and automatically exchanged with relevant EU Member States.

II/ The core income generating activities in 2.2 jurisdictions

According to Criterion 2.2: "*The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction*". The jurisdictions which raised concerns were asked to address these through the imposition of substance requirements, where appropriate. It is considered that those substance requirements should mirror those used in the FHTP in the context of specified preferential regimes.

A taxpayer should not be able to avoid the substantial activity requirements and still benefit from a low or no tax rate simply by moving to a 2.2 jurisdiction which at present is not subject to the substance requirements; rather, the same test for carrying out the core income generating activities in a jurisdiction should apply equally whether these are carried out in a preferential regime or in a 2.2 jurisdiction In fact, the need for this approach has been underlined by some members of the Inclusive Framework which are now adding substantial activity requirements to their preferential regimes, and have expressed concern that they may be at a competitive disadvantage if taxpayers relocate to a zero tax jurisdiction rather than comply with the new requirements. Thus, there is a strong level playing field argument that points in this direction.

In the context of FHTP assessments, the substantial activities criterion requires that jurisdictions ensure that core activities relevant to the regime type are undertaken by the taxpayer wishing to benefit from the regime (or are undertaken in the jurisdiction). The FHTP guidance on substantial activities further notes that core income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities. Finally, it requires the jurisdiction to have a transparent mechanism to ensure taxpayer compliance and to deny benefits if these core income generating activities are not undertaken by the taxpayer or do not occur within the jurisdiction. For IP regimes, specific substance requirements apply, namely the nexus approach.

a. Non-IP Substantial Activities Test

For companies dealing with assets other than IP, the substance requirements would apply to the same types of geographically mobile activities which have typically been the focus of the preferential regimes. 2.2 Jurisdictions would be required to meet the same substantial activities test for each sector, demonstrating that the core income generating activities are undertaken by the entity (or in the jurisdiction), involving an adequate number of employees and expenditure, supported by effective enforcement mechanisms. Annex 2 of this paper contains the 2017 FHTP Guidance on non-IP regimes which will have to be considered as the guidance for this exercise to be applied by analogy.

This would include fund managers as this is a mobile activity within the scope. However, collective investment funds (CIVs) are of a different nature, except in rare circumstances where the manager and the CIV form one legal entity. Therefore, the usual substance requirements cannot automatically be applied to CIVs. Thus, and in part similar to pure equity holding companies, reduced substantial activities requirements adapted to CIVs should apply Requirements in this regard can be paralleled with EU legislation on investment funds, in particular Directive 2011/61/EU on Alternative Investment Fund Managers.

b. Substance requirements for IP income

Income derived from IP assets can pose a higher risk of artificial profit shifting than non-IP assets. This is reflected in international standards in the field of taxation, which require that income deriving from IP assets must be subject to specific substantial activity requirements. For example, the FHTP's approach to income deriving from IP assets in the context of preferential regimes requires that the tax benefits a company can derive are conditional on the extent of substantial R&D activities of taxpayers receiving benefits income deriving from IP assets. This approach uses expenditures as a proxy for substantial activities to calculate the proportion of income that may enjoy the tax benefit ('The Nexus approach').

In the context of 2.2 jurisdictions, the absence of a preferential regime poses significant challenges to applying the Nexus approach. The overall aim in this context is not to calculate the portion of a company's intangible asset income that can take advantage of a preferential tax rate, but rather to determine whether a company generating income from intangible assets can incorporate or operate within a 2.2 jurisdiction. Therefore, while the focus of the Nexus approach on intellectual property derived from local R&D activities is acceptable as a standard for preferential IP regimes, it could in this context prohibit genuine commercial activities by failing to recognise other intangible assets and different ways in which those assets can be created or otherwise exploited through core income generating activities.

Any approach to substance requirements for IP income must therefore be effective, proportionate and both: (i) adequately address the higher risk of artificial profit shifting posed by income derived from IP assets in certain scenarios; and (ii) not inadvertently prohibit activities that constitute real economic activity

Strengthened general substantial activities approach

The approach that meets these requirements:

1) applies a targeted version of the general substantial activities approach to income derived from intangible assets in low risk scenarios;

2) includes a rebuttable presumption that the test is failed in these situations absent local R&D activities (for IP assets) or local marketing and branding activities (for non-IP intangible assets);

3) Makes the rebuttal of that presumption contingent on a taxpayer being able to evidence that it undertakes the substantive activities supporting intangible asset income, and makes it subject to enhanced reporting and monitoring requirements regardless of the decision taken by the 2.2 jurisdiction on the appropriateness of this substance;

4) presumes the non-compliance of companies that merely passively holds and generates income from intangible assets within higher risk scenarios.

b.1. Core Income generating activities for income deriving from IP assets

For intellectual property assets such as patents it is expected that core income generating activities include R&D activities.

For non-trade intangible assets such as brand, trademark and customer data it is expected that the core income generating activities include marketing, branding and distribution activities.

However the core income generating activities associated with an intangible asset will ultimately depend on the nature of the asset e.g. whether it's a patent, technical know-how, a trademark, customer lists or brand/goodwill.

They will also depend on how that asset is being used to generate income for the company e.g. whether it is being licenced or used to generate income from trading activities, such as the provision of services to third-party customers.

In certain situations therefore, a company might be given the possibility to prove that it is undertaking other core income generating activities associated with intangible asset income without specifically undertaking R&D, marketing and branding. Those activities might include:

- Taking the strategic decisions and managing (as well as bearing) the principal risks relating to the development and subsequent exploitation of the intangible asset; or

- Taking the strategic decisions and managing (as well as bearing) the principal risks relating to the third-party acquisition and subsequent exploitation of the intangible asset; or

- Carrying on the underlying trading activities through which the intangible assets are exploited and which lead to the generation of revenue from third-parties.

These activities, as well as R&D, branding and distribution activities which remain the main core activities to be looked at, would require the necessary staff, premises and equipment. Therefore, it would require more than local staff passively holding intangible assets whose creation and exploitation is a function of decisions made and activities performed outside of the jurisdiction.

They equally wouldn't be satisfied by the periodic decisions of non-resident board members, with the need instead for local, permanent and qualified staff making active and ongoing decisions in relation to the generation of income in the 2.2 jurisdiction.

b.2. Higher-risk scenarios – involvement of foreign related parties

The risks of artificial profit shifting are likely to be greater where a company

(a) owns an intangible asset that has been acquired from related parties or obtained through the funding of overseas R&D activities e.g. under a cost-sharing agreement; and
(b) is licenced to foreign related parties or monetised through activities performed by foreign related parties (e.g. foreign-related parties are paid to develop and sell a product in which the intangible asset is embedded).

To mitigate this greater risk, there should be a rebuttable presumption that the core income generating activities test is not satisfied in these scenarios, even if there are local activities that would, under a transfer pricing analysis, entitle the company to some allocation of taxable profits.

Companies could be given the ability to challenge this default presumption, and evidence how the income being generated in these higher risk situations is directly linked and justified by activities undertaken in the local jurisdiction rather than overseas.

This would need to be a high evidential threshold. Companies would, for example, need to evidence that, in addition or alternatively to R&D, branding and distribution activities, a high degree of control over the development, exploitation, maintenance, enhancement and protection of the intangible asset is, and historically has been, exercised by full time highly skilled employees that permanently reside and perform their core activities within the 2.2. jurisdiction. They must be able to support these evidences through the provision of additional information including:

- Detailed business plans which allow to clearly ascertain the commercial rationale of holding IP assets in the jurisdiction,

- employee information including level of experience, type of contracts, qualifications, duration of employment,

- concrete evidence that decision making is taking place within the jurisdiction.

This information would have to prove that in the jurisdiction there is more than local staff passively holding intangible assets whose creation and exploitation is a function of decisions made and activities performed outside of the jurisdiction.

This test will not be satisfied by mere periodic decisions of non-resident board members, with the need instead for local, permanent and qualified staff making active and regular decisions in relation to all the activities linked to the generation of IP income.

In order to further mitigate the higher level of risk that these scenarios pose, even where a taxpayer is able to rebut the presumption (i.e. it can demonstrate that it undertakes the substantive activities supporting intangible asset income) the 2.2 jurisdiction would be required to disclose the full evidence to the competent authority in the country of residence/relevant jurisdiction. (This may require that legislation be put in place that requires enhanced reporting from companies that fall into this category). This would allow Member States to review whether the testing being implemented by 2.2 jurisdictions' competent authorities in higher risk scenarios adequately mitigated tax risks.

The effectiveness and proportionality of the new legislation reflecting this approach will be subject to review after 1 year of application by the relevant jurisdictions. Since the new legislation is requested to be in place as of 1 January 2019 and will be immediately applicable to new companies (as well as to new activities and new IP assets), while existing companies (or existing activities and existing IP assets) will be given 6 months to adapt (i.e. by 1 July 2019 at the latest), the COCG will review this approach in July 2020 (1 year after the new legislation has been applicable to all companies) with a view to considering possible amendments.

III/ Implementation by 2.2 jurisdictions and consequences for non-compliance

A 2.2 jurisdiction would implement the substantial activities requirement in three key steps:

(1) identify the relevant activities in their jurisdiction;
(2) impose substance requirements;
(3) ensure there are enforcement provisions in place.

The first obligation for the 2.2 jurisdictions is to identify the relevant categories of activities in the jurisdiction in respect of which substance requirements would apply, including at least banking, insurance, fund management, financing, leasing, headquarters, and shipping. The 2.2 jurisdictions may be able to identify these categories of activity through existing or newly introduced regulatory requirements or by obtaining other information from reporting requirements or service providers. Alternatively, if it is administratively easier, a jurisdiction could apply the substance requirements to all businesses but then reduce requirements / carve out those entities that are not in scope. A jurisdiction may also decide to exempt local businesses that are not in scope of the work on harmful tax practices, such as hotels and retail, or alternatively have them covered as presumably such entities would have no difficulty in meeting the requirements.

Second, for each set of activities, the 2.2 jurisdiction would need to impose substance requirements to ensure consistency with the COCG and FHTP guidance. This may require legislative changes, as is the case for many of the other Inclusive Framework members, and which many of the 2.2 jurisdictions have already indicated their willingness to do.

Third, the 2.2 jurisdiction would need to implement adequate enforcement and sanction mechanisms to ensure compliance by the relevant individual entities with substance requirements. This would need to include mechanisms to identify which entities are conducting the relevant categories of activities, and to detect and enforce the substantial activities requirements for entities which purport to have substantial activities but in fact do not meet the requirements. To be able to do so, a 2.2 jurisdiction would need to require each entity in scope to prepare and file information on at least business type (to identify the type of mobile activity); amount and type (e.g. rents, royalties, dividends, sales, services) of gross income; amount and type of expenses and assets; premises, and number of employees, specifying the number of full time employees. In addition, each entity must be required to prepare and file information showing that it has conducted relevant core income generating activities such as R&D, marketing, branding and exploitation within the 2.2 jurisdiction.

Ordinarily in the context of a preferential regime, where a taxpayer has failed to meet the substantial activity requirements the result should be that the tax benefits of the regime are denied. This would not apply in the 2.2 context, but there would need to be an equivalent level of enforcement. The consequences where an entity fails the substance requirements should include rigorous, effective and dissuasive regulatory penalties and enhanced spontaneous exchange with jurisdictions of residence (e.g. of a party making a deductible payment to such a company) and ultimately, where other sanctions produce no results, this should lead to the striking off the register of such an entity. This should be complemented by a commitment by the 2.2 jurisdiction to continue enforcement efforts and remedy any shortcomings in the enforcement process.

IV/ Review and monitoring of the 2.2 jurisdictions' implementation of the substance requirements

Drawing on the process and practice of the Code of Conduct Group and FHTP, there are two parts to the review to ensure a 2.2 jurisdiction had implemented the substance requirements: a review of the legal and administrative framework and monitoring of effectiveness in practice.

The first part in the assessment of the 2.2 jurisdiction would involve a review of the legal and administrative framework (whether regulatory, commercial tax, or other legislation) and other information provided by the jurisdiction to determine whether the substance requirements are met. This includes whether the legislation requires substance, and whether there are adequate enforcement and sanction provisions, as well as information on the mechanism for overseeing these provisions (such as which agency will enforce the requirements, how this will be done and with which resources).

The second part is an ongoing annual monitoring process to ensure that the legislative and enforcement provisions were being adequately administered by the 2.2 jurisdiction at a systemic level. This includes collecting information on the core income generating activities for the activity, requirements for an adequate number of full-time employees with necessary qualifications and for an adequate amount of operating expenditures to undertake core income generating activities, enforcement mechanisms and statistics such as the aggregate numbers of entities, aggregate amount of income, employees and expenditure in that type of activity, and information on the number of entities which have been found to not meet the requirements.

This information is used as a high level indicator as to whether the law or enforcement mechanisms are deficient and need to be remedied by the jurisdiction. Moreover, given the fact that the Global Forum initiated a close cooperation on the 2.2. issue, on site assessments on the adherence of the above standards by this forum could be an option.

The existing review documents (i.e. the self-review template and monitoring questionnaire) could be used, with slight adjustments to accommodate the analytical approach.

V/ Further transparency requirements

Three requirements are set out below to enhance transparency. These draw on existing transparency initiatives related to both the EU and the OECD. Those requirements are not mutually exclusive and could be applied simultaneously by the 2.2 jurisdictions.

1 – Spontaneous exchange on specific risk issues

Spontaneous exchange of information has long been a part of the EU work and the FHTP framework for addressing harmful tax practices to better equip other countries to enforce their own tax laws and identify BEPS concerns. For example, in the FHTP context, specific requirements have been agreed for spontaneous exchange of information on tax rulings (including rulings related to preferential regimes), on certain features of IP regimes, and on downward adjustments.

In this vein, specific transparency requirements must be devised as a backstop to the substance requirements for 2.2 jurisdictions. The information filed by entities that are in scope (see Section "*Implementation by 2.2 jurisdictions and consequences for non-compliance*", fourth paragraph) must be spontaneously exchanged with EU members where either the legal or beneficial owner is tax resident, which then links also to the availability of legal and beneficial ownership information discussed below. The burden of proof whether substance criteria are met is on the taxpayer.

In these cases, it could be possible to use the FHTP transparency framework for spontaneous exchange of information on tax rulings. For example, the transparency framework sets out with which jurisdictions information must be exchanged, such as country of residence of related party which is on the other side of a relevant transaction, and the immediate parent and ultimate parent company. It would also be possible to design a standardised format for such exchanges, using a similar template and XML Schema as is used for the exchange on rulings and which was developed in cooperation with the EU).

2 – Beneficial ownership

The need for accurate and accessible beneficial ownership information is part of the international tax and anti-money laundering standards. EU Member States have been ambitious on this agenda, most recently in December 2017 by reaching political agreement on the Fifth Anti-Money Laundering Directive, which will ensure the creation of beneficial ownership registers in all EU Member States, as well as their interconnectivity and their access to the public under certain circumstances. This is the latest step in the wider strategy to achieve greater efficiency in access to ownership information, including through the Fourth Anti-Money Laundering Directive, the DAC 5, the regulation on the interconnection of corporate registers and initial scoping efforts at OECD's Working Party 10 with respect to the standardisation of the structuring of ownership information held in central repositories in electronically searchable form.

To further drive forward this agenda, a 2.2 jurisdiction could be required to ensure that every company or other body corporate created under its laws would be subject to enhanced transparency requirements that ensure that ownership information is available and accessible in a timely, accurate and electronically searchable manner. This could be done, for instance, by creating more efficient exchange of information on beneficial ownership through efficient access to registries being made accessible to designated authorities from participating jurisdictions.

As such, 2.2 jurisdictions would need to ensure that legal and beneficial ownership information in relation to bodies corporate is kept up to date and can be readily queried in an electronic manner, therewith allowing relevant international authorities to ascertain the ownership of an entity in a real-time or close to real time manner.

This would allow each 2.2 jurisdiction to keep its own, domestic repositories in place, while enabling the instantaneous query of ownership information across jurisdictions through, for instance, a single interconnected query platform.

In this context, 2.2 jurisdictions would be expected to have fully accurate legal ownership information in relation to their bodies corporate available in all instances, as well as to require that up-to-date beneficial ownership information be made available and kept up to date by bodies corporate, to the extent obtainable under domestic law and taking into account the circumstances of publically traded entities. In light of the experience in the EU of implementing enhanced access to beneficial ownership information, the implementation of the enhanced transparency requirements in 2.2 jurisdictions could be introduced in a staged manner to ensure the greatest quality and usability of the data, effectiveness of access agreements and so on.

More broadly, the efforts made at the EU level and with the 2.2 jurisdictions could be supported and expanded internationally including through ongoing work within through the OECD's WP10.

3 – Mandatory disclosure rules

The relevance of mandatory disclosure rules in the offshore tax avoidance and evasion field is now heightened, with the EU directive ("DAC6") and the approval of rules by Working Party 10 and Working Party 11 on mandatory disclosure rules for CRS Avoidance Arrangement and Opaque Offshore Structures. Building on this work, a third option for enhanced transparency would be to require 2.2 jurisdictions to introduce mandatory disclosure rules consistent with DAC6 and the OECD work. Given that many of the 2.2 jurisdictions were actively involved in the discussions in WP10 and WP11, they are already very familiar with these rules (and thus the equivalent hallmark D in DAC6).

These rules would require such promoters and service providers to disclose information on the arrangement or structure to the competent authority (which is identified in accordance with a test set out in domestic law on the basis of the one set out in DAC6).

Information on those schemes (including the identity of any user or beneficial owner) would then be exchanged with the tax authorities of jurisdiction in which the users and/or beneficial owners are resident in accordance with the requirements of the applicable information exchange agreement.

Annex 1 to the ANNEX

Scope of criterion 2.2

1. For the purposes of application of criterion 2.2, the absence of a corporate tax or applying a nominal corporate tax rate equal to zero or almost zero by a jurisdiction should be regarded as within the scope of Paragraph A of the Code of Conduct for Business Taxation of 1 December 1997 (Code of Conduct).[1]

2. In this respect, where criterion 2.1 is inapplicable solely due to the fact that the jurisdiction concerned does not meet the gateway criterion under Paragraph B of the Code of Conduct [2], because of the "absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero"[3], then the five factors identified in paragraph B of the Code of Conduct should be applied by analogy to assess whether the criterion 2.2[4] has been met.

3. In the context of criterion 2.2 the fact of absence of a corporate tax or applying a nominal corporate tax rate equal to zero or almost zero can not alone be a reason for concluding that a jurisdiction does not meet the requirements of criterion 2.2.

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1 "Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community." (OJ C 2, 06.01.1998, p. 3)

2 "Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor." (OJ C 2, 06.01.1998, p. 3)

3 This may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

4 Criterion 2.2 reads as follows: *"The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction."*

4. A jurisdiction should be deemed as non-compliant with criterion 2.2 if it refuses to engage in a meaningful dialogue or does not provide the information or explanations that the Code of Conduct Group may reasonably require or otherwise does not cooperate with the Code of Conduct Group where it needs to ascertain compliance of that jurisdiction with criterion 2.2 in the conduct of the screening process.

Terms of reference for the application of the Code test by analogy

A. General framework

1. Criterion from ECOFIN Council Conclusion on 8th November 2016

The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction.

2. Scope of Criterion 2.2 (ECOFIN February 2017)

1. For the purposes of application of criterion 2.2, the absence of a corporate tax or applying a nominal corporate tax rate equal to zero or almost zero by a jurisdiction should be regarded as within the scope of Paragraph A of the Code of Conduct for Business Taxation of 1 December 1997 (Code of Conduct).[5]

2. In this respect, where criterion 2.1 is inapplicable solely due to the fact that the jurisdiction concerned does not meet the gateway criterion under Paragraph B of the Code of Conduct[6]*, because of the "absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero"*[7]*, then the five factors identified in paragraph B of the Code of Conduct should be applied by analogy to assess whether the criterion 2.2*[8] *has been met.*

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5 *"Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community." (OJ C 2, 06.01.1998, p. 3)*

6 *"Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor." (OJ C 2, 06.01.1998, p. 3)*

7 *This may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.*

8 *Criterion 2.2 reads as follows: "The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction."*

3. In the context of criterion 2.2 the fact of absence of a corporate tax or applying a nominal corporate tax rate equal to zero or almost zero cannot alone be a reason for concluding that a jurisdiction does not meet the requirements of criterion 2.2.

4. A jurisdiction should be deemed as non-compliant with criterion 2.2 if it refuses to engage in a meaningful dialogue or does not provide the information or explanations that the Code of Conduct Group may reasonably require or otherwise does not cooperate with the Code of Conduct Group where it needs to ascertain compliance of that jurisdiction with criterion 2.2 in the conduct of the screening process.

3. General remarks

- Scope of Criterion 2.2 as defined by ECOFIN considers the absence of a corporate tax rate or a nominal tax rate equal to zero or almost zero in a jurisdiction as a "measure" significantly affecting the location of business activities (Paragraph A of the Code of Conduct).
- To this extent, Criterion 2.2 is aimed at verifying whether this "measure" facilitates offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction.
- Criterion 2.2 applies only when the standard code assessment (i.e. criterion 2.1) cannot be applied because of the absence in a third country jurisdiction of a corporate tax system or because the jurisdiction applies a nominal corporate tax rate equal to zero or almost zero.
- Criterion 2.2 assesses the legal framework and certain economic evidences of a jurisdiction with regard to the five criteria established under paragraph B of the Code of Conduct to be interpreted by analogy.
- Advantages granted by a third country jurisdictions influencing in a significant way the location of business activities have to be seen in connection with a nominal corporate tax rate equal to zero or almost zero as well as in connection with the absence of corporate taxation, to the extent in both cases the standard Code of Conduct test could not be applied. These latter features have in fact to be considered *per se* as advantages to be assessed under this code test.

- In general terms, any guidance developed by the COCG over the years for assessing tax measures within the scope of the 1998 Code of Conduct should be applied consistently and by analogy for the purpose of this test[9].
- A jurisdiction can only be deemed to have failed the assessment under this criterion when 'offshore structures and arrangements attracting profits which do not reflect real economic activity in the jurisdiction' are due to rules or practices, including outside the taxation area, which a jurisdiction can reasonably be asked to amend, or are due to a lack of those rules and requirements needed to be compliant with this test that a jurisdiction can reasonably be asked to introduce.
- The introduction of a CIT system or a positive CIT rate is not amongst the actions that a third country jurisdiction can be asked to take in order to be in line with the requirements under this test, since the absence of a corporate tax base or a zero or almost zero level tax rate cannot by itself be deemed as criterion for evaluating a jurisdiction as non-compliant.
- Nonetheless, criterion 2.2 implies automatic non-compliance for those jurisdictions that refuse to cooperate with the EU for the assessment of their legal framework.

B. Gateway test

1. Gateway criterion as it reads now in the Code of Conduct

   "Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this Code."

2. Guidelines for application by analogy

- The functioning of the Gateway test seems rather clear from the definition of scope of Criterion 2.2 as agreed by Ecofin in February this year.

[9] See doc. 14039/98 of 11 December 1998 "Code of Conduct (Business Taxation) – Interpretation of Criteria" and its further updates.

- In particular, this test is satisfied when "*criterion 2.1 is inapplicable solely due to the fact that the jurisdiction concerned does not meet the gateway criterion under Paragraph B of the Code of Conduct, because of the "absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero"*

C. Criteria 1 and 2

1. Criterion 1 of the current Code Criteria as it is now

   "*Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents*"

2. Criterion 2 of the current Code Criteria as it is now

   "Whether advantages are ring-fenced from domestic market, so they do not affect the national tax base"

3. Guidelines for application by analogy

- For the purpose of applying criterion 2.2., "advantages" should be understood as the existence of zero or almost zero taxation or the absence of CIT.

- Factor 1 as well as factor 2 of the current code criteria contain two main elements: (a) legal ring-fencing and (b) de-facto ring-fencing.

- De jure ring-fencing occurs when advantages are only granted to non-residents by the laws and regulations governing the establishment and operations of businesses in a given jurisdiction.

- Where there is no an effective CIT-system in place, it should be then assessed whether aspects of the legal framework, including non-CIT aspects, effectively provide for a ring-fenced scenario.

- An example of that would be non-tax requirements for companies to allow for the residence or for the access to the domestic market of the tested jurisdiction.

- For this purpose, any measure leading to a different treatment between domestic companies and companies held by non-residents or whose activities are disconnected from the domestic market shall be assessed.

- If for instance a jurisdiction grants "advantages" to a company only if it abstains from activities in the local economy (criterion 2) or only to the extent such activities are dependent on a specific business license (criterion 1 and 2) or only to the extent the activities are undertaken by non-residents (criterion 1), this could be assessed as a possible feature of a ring fencing system in place. By analogy this could also be relevant for other taxes (i.e. other than CIT).

- De-facto ring-fencing usually refers to a situation whereby the advantage is not explicitly granted by a country only to non-residents although, in fact, it is enjoyed only or almost only by non-residents.

- As to the de-facto ring-fencing, it is usually considered how many of the taxpayers benefitting from the advantage are in fact non-residents. If, for instance all or nearly all of the subjects benefitting from zero taxation are non-residents (including domestic companies with foreign shareholding), sub-criteria 1 (b) as well as 2 (b) would be considered as met (i.e. the jurisdiction would be deemed to be non-compliant under this step of the Code test).

D. Criterion 3

1. Criterion 3 of the current Code Criteria as it is now

"Whether advantages are granted even without any real economic activity and substantial economic presence with the Member State offering such tax advantages"

2. Guidelines for application by analogy

In order to evaluate whether advantages are granted even without any real economic activity and substantial economic presence, it has to be ascertained:

- whether a jurisdiction does require a company or any other undertaking (e.g. for its incorporation and/or its operations) the carrying out of real economic activities and a substantial economic presence:
    - "Real economic activity" relates to the nature of the activity that benefits from the non-taxation at issue.
    - "Substantial economic presence" relates to the factual manifestations of the activity that benefits from the non-taxation at issue.
    - By way of example and under the assumption that, in general, elements considered in the past by the COCG are relevant also for this analysis, the current assessment should consider the following elements taking into account the features of the industry/sector in question: adequate level of employees, adequate level of annual expenditure to be incurred; physical offices and premises, investments or relevant types of activities to be undertaken.
- whether there is an adequate de jure and de facto link between real economic activity carried on in the jurisdiction and the profits which are not subject to taxation;

- whether governmental authorities, including tax authorities of a jurisdiction, are capable of (and are actually doing) investigations on the carrying out of real economic activities and a substantial economic presence on its territory, and exchanges of relevant information with other tax authorities;

- whether there are any sanctions for failing to meet substantial activities requirements.

E. Criterion 4

1. Criterion 4 of the current Code Criteria as it is now

"Whether the rules for profit determination in respect of activities within a multinational group of companies depart from internationally accepted principles, notably the rules agreed upon within the OECD"

2. Guidelines for application by analogy

- In assessing the adherence of profit determination rules to internationally agreed standards (e.g. OECD TP Guidelines or other similar accounting standards) first of all it should be verified if and to what extent this analysis is relevant for jurisdictions not applying a CIT system.

- To this aim it seems relevant to consider that a jurisdiction not applying a CIT system should not negatively affect a proper allocation of profits departing from internationally agreed standards. Jurisdictions should take appropriate steps in ensuring taxing countries are able to exercise their taxing rights i.e. via CBCR, transparency and other modes of information sharing.

- Where relevant, it should be ascertained if OECD's agreed principles or similar accounting standards for the determination of profits have been endorsed in a given jurisdiction.

- To this regard, it is critical to ascertain how these rules are implemented and consolidated in the jurisdictions concerned. In the absence of corporate income taxation in a given jurisdiction, also alternative transfer pricing rules can be taken into account, verifying whether they are comparable and compatible with internationally agreed principles (for instance a fair market value approach under international accounting principles).

- This Criterion shall prevent from allowing multinational companies to use transfer pricing rules departing from the OECD Transfer Pricing Guidelines in order to allocate their profits to zero tax jurisdictions.

- Answers to questions from 2.9 to 2. 12 should give sufficient information on how profits are determined highlighting any important department from internationally agreed standards.

F. Criterion 5

1. Criterion 5 of the current Code Criteria as it is now

"*Whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way*"

2. Guidelines for application by analogy

- Criterion 5 shall evaluate whether certain features of a legal system, including the establishment of a business on its territory, lack sufficient level of transparency.

- More specifically, it has to be assessed whether any elements of the legal system, including the granting of tax residence or the setting up of companies can be granted on a discretional basis or whether it is bound by the law, verifying whether any legal provision, including non-tax provisions, can be deemed to be discretionary in matters related to the setting up of a company in that jurisdiction.

- This factor shall prevent a jurisdiction from having an insufficient level of transparency within its regulatory framework, considering that advantages as considered in this Code test stem from the registration of a company in a jurisdiction.

- Answers to questions from 2.13 to 2. 16 should give sufficient information on how transparency is ensured in a jurisdiction on certain steps to be undertaken by companies in order to benefit from the advantages provided therein.

OECD FHTP Guidance on Substantial activities in regimes other than IP regimes

Introduction

1. The 2015 Report on Action 5 (OECD, 2015a) contained detailed guidance on the application of the substantial activities criterion to IP regimes as well as more general guidance for the application of the substantial activities criterion to non-IP regimes. In part this recognised that applying the substantial activities criterion to non-IP regimes is a relatively more straightforward and simpler exercise as the value creation is primarily driven by the services provided rather than a separate IP asset that can be shifted.

2. The general guidance in the report for how to assess substantial activities in the context of regimes other than IP regimes is consistent with the nexus approach, which permits IP regimes to provide benefits to taxpayers only to the extent that those taxpayers themselves undertook the R&D activities (or, for IP regimes outside the European Union, to the extent that the R&D activities took place within the jurisdiction providing the benefits). The report stated that "the same principle can also be applied so that [regimes other than IP regimes] would only be found to meet the substantial activity requirement if they also granted benefits only to qualifying taxpayers to the extent those taxpayers undertook the core income generating activities required to produce the type of business income covered by the preferential regime."

3. The remainder of this annex has two sections. Section 2 considers how outputs from other Actions affect the need for a substantial activities requirement in the context of non-IP regimes. Section 2 concludes that Actions 8-10 and Action 13 give jurisdictions better tools to prevent profit-shifting to preferential regimes that may have little substance. However, while such other actions already provide a certain level of protection, they do not eliminate the need for a substantial activities requirement as specifically recognised in the Report. Section 3 contains a two-step approach to implementing the substantial activities requirement in the context of non-IP regimes.

Substantial activities under other Actions

4. In the context of certain holding company regimes, the Report suggested that concerns about a lack of substantial activities might already be addressed in other work or under other existing factors.[2] Along with the other work mentioned in the Report (OECD, 2015a) on Action 5, the Reports on Actions 8-10 (OECD, 2015b) and Action 13 (OECD, 2015c) also address many concerns about a lack of substantial activities in non-IP regimes.

• **Transfer pricing** – The outputs from Actions 8-10 set out updated guidance on transfer pricing, which ensures transfer pricing outcomes are better aligned with value creation. The effect of this new guidance is that it will be less likely for significant income to be allocated to an entity which lacks substantial activities and which was established in a jurisdiction merely to receive benefits under a non-IP regime.

• **Country-by-country reporting** – Action 13 established a minimum standard on country-by-country (CbC) reporting. This minimum standard reflects a commitment to implement the common template for CbC reporting. The effect of CbC reporting is that jurisdictions will have relevant information necessary to determine whether resident companies have related entities which lack substantial activities and which are established in a jurisdiction merely to receive benefits under a non-IP regime. In particular, CbC reporting will provide jurisdictions with country-by-country breakdowns of related party revenues, profits before income tax, income tax paid and accrued, number of employees, tangible assets, and other indicators of economic activities within large MNE groups.

5. Actions 8-10 and Action 13 do not eliminate the need for a substantial activities requirement, but they complement the substantial activities requirement by giving jurisdictions better tools to protect against profit-shifting to preferential regimes with little substance. The need for a robust substantial activities requirement for non-IP regimes therefore needs to be seen in light of the overall BEPS Action Plan.

Possible substantial activities analysis for preferential regimes other than IP regimes

6. Although the Actions discussed above may limit the need for a substantial activities requirement in non-IP regimes, they do not eliminate this need. Jurisdictions with such regimes must therefore implement the principles set out in the Action 5 Report (OECD, 2015a) to ensure that preferential regimes other than IP regimes require substantial activities in order to provide benefits. This section sets forth a two-step approach for the implementation of substantial activities in non-IP regimes under which (1) jurisdictions would require activities and establish mechanisms to review compliance with this requirement, and (2) the FHTP would monitor compliance.

Requiring substantial activities

7. In order to comply with the principles set out in the Action 5 Report (OECD, 2015a), non-IP regimes must be designed to ensure that benefits are available only when the core income generating activities are undertaken by the qualifying taxpayer (or, for regimes outside the European Union, when the core income generating activities are undertaken in the jurisdiction providing benefits).[3] Jurisdictions offering non-IP regimes that are in scope of the FHTP work therefore need to design the regime in a way that ensures that core activities relevant to the regime type are undertaken by the taxpayer wishing to benefit from the regime.

8. Core income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities. As set out in the Action 5 Report (OECD, 2015a), such activities could include the following.

• **Headquarters regimes –** The core income generating activities in a headquarters company could include taking relevant management decisions; incurring expenditures on behalf of group entities; and co-ordinating group activities.

• **Distribution and service centre regimes** – The core income generating activities in a distribution or service centre company could include activities such as transporting and storing goods; managing stocks and taking orders; and providing consulting or other administrative services.

• **Financing and leasing regimes** – The core income generating activities in a financing or leasing company could include agreeing funding terms; identifying and acquiring assets to be leased (in the case of leasing); setting the terms and duration of any financing or leasing; monitoring and revising any agreements; and managing any risks.

• **Fund management regimes** – The core income generating activities for a fund manager could include taking decisions on the holding and selling of investments; calculating risks and reserves; taking decisions on currency or interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for government authorities and investors.

• **Banking regimes** – The core income generating activities for banking companies could include raising funds; managing risk including credit, currency and interest risk; taking hedging positions; providing loans, credit or other financial services to customers; managing regulatory capital; and preparing regulatory reports and returns.

• **Insurance regimes** – The core income generating activities for insurance companies could include predicting and calculating risk, insuring or re-insuring against risk, and providing client services.

• **Shipping regimes** – The core income generating activities for shipping companies could include managing the crew (including hiring, paying, and overseeing crewmembers); hauling and maintaining ships; overseeing and tracking deliveries; determining what goods to order and when to deliver them; and organising and overseeing voyages.

• **Holding company regimes** – For holding companies that hold a variety of assets and earn different types of income (e.g. interest, rents, and royalties), the core income generating activities would be those activities that are associated with the income that the holding companies earn, as determined by the discussion above. (For example, a holding company that receives benefits for banking income would be required to have the core income generating activities associated with banking companies.) For pure equity holding companies, which only hold equity participations and earn only dividends and capital gains, the Action 5 Report makes clear that there is less concern of such regimes being used for BEPS. The Report states that such holding companies must respect all applicable corporate law filing requirements in order to meet the substantial activities requirement, and suggests that they should have the people and the premises for holding and managing equity participations. Beyond this, because such regimes are provided in part to avoid double taxation, there should be no expectation of a correlation between income-generating activities and benefits. In other words, holding company regimes, including participation exemptions, are particular as the tax exemption / tax benefit is based on policy considerations other than notions of value creation.

9. For "internal" income shifting (i.e. the shifting of income from other domestic sources into the regime to avoid the otherwise applicable higher domestic tax rate), jurisdictions can be expected to already be addressing such problems in order to protect their own revenue bases. For "external" income shifting (i.e. shifting income from foreign sources into the regime to avoid the otherwise applicable higher foreign tax rate), jurisdictions may not have the same built-in incentive to take action. Along with articulating the core income generating activities that are required for a taxpayer to benefit from a regime, jurisdictions providing benefits must therefore also have a transparent mechanism to review taxpayer compliance and to deny benefits if these core income generating activities are not undertaken by the taxpayer or do not occur within the jurisdiction. Jurisdictions must demonstrate that this mechanism ensures that taxpayers comply.

10. As part of this mechanism, jurisdictions would be expected to gather and maintain information on the identity (and hence the number) of taxpayers benefitting from the regime. Furthermore, they should gather information on the type and level of activity performed. Such information includes information on whether the taxpayer performs the core activities for which the regime is designed, the level of core activities undertaken, and the number of qualified full-time employees and amount of operating expenditures associated with the core activities. Finally, the jurisdiction should gather information on the amount of net income for which each taxpayer receives benefits under the regime because, for instance, a disproportionately large net income relative to benefitting core activities may indicate that other non-benefitting activities/value drivers may be responsible for the reported net income. In this regard, special considerations would need to apply for holding companies and non-income based taxes such as tonnage tax regimes.

11. Pure equity holding company regimes would not require this type of information gathering. The nature of such regimes is that they are typically granted through statutory exemptions, making it difficult to gather information on their activities through the tax return. This reflects the point, discussed above, that holding company regimes, including participation exemptions, are particular as the tax exemption/tax benefit is based on policy considerations other than notions of value creation.

12. For regimes which do not have income reporting because they implement a non-income based tax in place of income tax or where such data is not collected as part of the tax return or is not otherwise easily obtainable, such as certain tonnage tax regimes, accounting profits or other similar statistics can be reported instead of the amount of net income benefitting from the regime.

13. The following are examples of the application of the substantial activities factor to non-IP regimes:

• **Example 1: Financing and leasing regime.** A regime requires benefitting taxpayers to undertake the leasing activities and operations in the jurisdiction, including identifying and acquiring the assets to be leased, negotiating the leasing terms, and managing the leases. The regime further requires that benefitting taxpayers incur at least EUR 5 million in annual business spending and employ an adequate number of qualified full-time employees to undertake the core activities (and at least three such employees) in the jurisdiction. The jurisdiction requires the taxpayer to report information annually on the income benefitting from the regime, as well as the type and level of activity performed to generate the income. Taxpayers which do not meet the requirements are denied the regime's benefits. This regime demonstrates that the core income generating activities occur in the jurisdiction and has a robust follow-up mechanism to ensure compliance. It therefore satisfies the requirement for having substantial activities in the jurisdiction.

• **Example 2: Headquarters regime.** A regime requires taxpayers to carry on headquarters activities in the jurisdiction, such as strategic business planning and development, supply chain management and co-ordination, and general management and administrative activities, including the control and provision of services to related group companies. The regime further requires taxpayers to incur at least EUR 3 million in annual business spending and employ an adequate number of qualified full-time employees, including managers and professionals, to undertake the core activities (and at least ten such employees) in the jurisdiction. The jurisdiction requires the taxpayer to report information annually on the income benefitting from the regime, as well as the type and level of activity performed to generate the income. Taxpayers which do not meet the requirements are denied the regime's benefits. This regime demonstrates that the core income generating activities occur in the jurisdiction and has a robust follow-up mechanism to ensure compliance. It therefore satisfies the requirement for having substantial activities in the jurisdiction.

FHTP monitoring

14. For non-IP regimes that have been subject to a substantial activities assessment, jurisdictions would need to establish monitoring procedures and notify the FHTP of how they define core income generating activities and how they review taxpayer compliance with the substantial activities requirement. The purpose of such monitoring is not to conduct a transfer pricing analysis but instead to confirm that the regime continues to operate consistently with the type and level of activities upon which the previous findings of the FHTP were based. Jurisdictions would also need to report on an annual basis on:

• the number of taxpayers applying for the regime;

• the number of taxpayers benefitting from the regime;

• the type of core activities undertaken by taxpayers benefitting from the regime;

• the quantity of core activities undertaken by taxpayers benefitting from the regime (as measured by the number of full-time employees and the amount of operating expenditures associated with these activities);

• the aggregate amount of net income benefitting from the regime (as discussed above, for regimes which do not have income reporting because they implement a non-income based tax in place of income tax or where such data is not collected as part of the tax return or is not otherwise easily obtainable, accounting profits or other similar statistics can be reported instead); and

• the number of taxpayers, if any, that no longer qualify for benefits in whole or in part under the regime.

15. To balance the importance of monitoring substantial activities in preferential regimes against the administrative burden of collecting the required information, monitoring would be required only with respect to taxpayers that are members of multinational enterprise groups with annual revenues in the preceding year of EUR 750 million or more – that is, taxpayers which are constituent entities of MNE groups required to file CbC reports, as set out in the Action 13 Report (OECD, 2015b) and subsequent guidance on CbC reporting. Monitoring would also not be required if the small number of taxpayers benefitting from a regime means that provision of the above information would have the effect of disclosing the identity of the taxpayer, and jurisdictions could establish de minimis exceptions to the monitoring requirement to prevent such disclosure.

16. Pure equity holding company regimes would not be subject to this type of monitoring, for the reasons discussed above. Furthermore, monitoring of pure equity holding companies is already accomplished through CbC reporting, which identifies such holding companies in an MNE group and allows determination of the key economic variables such as number of employees and tangible assets.